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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1960

No. 828

JOHN R. UPTON and ANNA L. S. UPTON,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MARGARET ST. AUBYN,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit

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Subject Index

	Page
Opinions below	2
Jurisdiction	2
Questions presented	2
Statutes involved	3
Statement	4
Reasons for granting the writ	10
1. Intra circuit conflicts	10
2. Important questions of federal law	12
3. Conflicts with applicable decisions of this court	15
4. Conflicts with the decrees of the California court in direct relation to this particular trust	17
Conclusion	17

Table of Authorities Cited

Cases	Pages
Blair vs Commissioner (1937) 300 U.S. 5, reversing CA 7th, 83 F. 2nd 655	12, 15, 16
Compagnie Generale Translantique vs Elting, 298 U.S. 217, 56 S.Ct. 77	11
Dickinson vs Petroleum Conversion Corp., 338 U.S. 507, 70 S.Ct. 322	11
Estate of Mary Jane Little, 30 TC 936	9
First National, etc. vs Howard (Sup. Ct. Texas, 1950) 229 SW 2nd 781	11

Pages

Freuler vs Helvering (1934) 291 U.S. 35, reversing CA 9th, 62 F. 2nd 733 ..... 12, 15, 16

Helvering vs Falk (1934) 291 U.S. 183 16

Little's Estate vs Commissioner, 274 F.2nd 718 ..... 10, 11, 12

Merle-Smith vs Commissioner (CA 2 1930) 42 F. 2nd 837 ..12, 16

Reynolds vs Cooper (1934) 291 U.S. 192 16

U. S. ex rel Robinson vs Johnston, 316 U.S. 649, 62 S.Ct. 1301 11

Statutes

Internal Revenue Code of 1939:
Section 23(m) 2, 3, 4, 8, 11, 12, 13, 14, 17
Section 114(b)(3), 26 USC 3, 8

Internal Revenue Code of 1954:
Section 611(b)(3) 4
Sections 7482 and 7483 9

Treasury Regulations:
Regulations 118, Section 39.23(m) 3

Revenue Act of 1928:
Section 23(l) 4

28 USC 1254(1) 2

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To the Honorable Earl Warren, Chief Justice of the United States and to the Associate Justices of the Supreme Court of the United States:

The undersigned, on behalf of the above-named petitioners, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the

Ninth Circuit, entered in two cases consolidated therein under Docket No. 16703.

OPINIONS BELOW

The opinion of the Tax Court (R. 111)[1] is reported in 32 TC 301. The opinion of the Court of Appeals is reported in 283 F. 2nd, p. 716 and is in the appendix hereto pp. 1 to 14. (Said appendix is separately presented as a matter of convenience.)

JURISDICTION

The judgment of the Court of Appeals was entered on September 27, 1960. Petitioners filed a timely petition for rehearing, which was denied December 19, 1960.

A motion for leave to file a second petition for rehearing and for reconsideration filed on January 17, 1961, was denied by order dated January 26, 1961. That order was vacated by the Court on February 27, 1961 and the motion was granted and the second petition for rehearing was filed on February 27, 1961. On March 10, 1961 the second petition for rehearing was denied.

The jurisdiction of this Court is invoked under 28 USC 1254(1).

QUESTIONS PRESENTED

1. Which is "the instrument creating the trust" under Sec. 23(m) of the Internal Revenue Code of 1939, the will, or a judicial decree entered 30 years after the testator's death or the will coupled with such decree?

[1] R. refers to the printed transcript of record in the Court of Appeals.

2. If the will creates the trust, is a direction therein to pay out the net income a pertinent provision within the meaning of Sec. 23(m) apportioning all the allowable percentage depletion deduction to the trustees, and none to the income beneficiaries, even though some of the depletion is lost thereby, particularly when the mineral corpus producing the income had a nominal value at the testator's death and when the allowable deduction for percentage depletion runs into hundreds of thosands of dollars?

3. If the judicial decree or the will coupled with such decree creates the trust, is the authorization by the decree of an agreement for the extraction of oil and gas not permitted by the will (i.e. because it might continue after the termination of the trust) upon condition imposed by the decree and not in the will that the royalty income be allocated between the income beneficiaries and the trustees, a pertinent provision within the meaning of Sec. 23(m) apportioning all the allowable percentage depletion deduction to the trustees and none to the income beneficiaries, even though some of the depletion deduction is lost thereby, or is it a determination by the state court "of the trust income allocable to each" within the meaning of Sec. 23(m), without any loss of the depletion deduction?

STATUTES INVOLVED

The statutes involved are Sections 23(m), 114(b)(1) and 114(b)(3) of the Internal Revenue Code of 1939, 26 USC. All pertinent provisions of these sections together with the applicable portions of the regulations (Regs. 118, Section

39.23(m)) are printed in the Appendix p. 16, et seq. The most important provision is Section 23(m) of the Internal Revenue Code of 1939, and more particularly the following portion thereof:

> ". . . In the case of property held in trust, the allowable deduction [for depletion] shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."[2]

STATEMENT

The facts, with exceptions not material here, were stipulated (R. 113).

William R. Sloan died in 1923 (R. 113) domiciled in Alameda County, California, leaving surviving his widow and two unmarried daughters (R. 113). His estate was distributed by a decree of final distribution entered on September 29, 1924 in the Superior Court of the State of California in and for the County of Alameda (R. 115-6), hereinafter called the California court.

The residuary testamentary trust created by his will required the trustees to "receive the rents, issues, profits and income" of the trust property, "and after paying all necessary and proper expenses incurred by them in the administration of" the trust to pay, with a small

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[2]This language first came into the law as Section 23(l) of the Revenue Act of 1928 and ever since has been reenacted without change. It is now found in Section 611(b)(3) of the Internal Revenue Code of 1954.

exception not material here, "the net rents, issues, profits and income" to the testator's widow during her life (R. 114) and upon her death directed "that all the rents, issues, profits and income" be paid to his two daughters in equal shares for their respective lives (R. 114). There were remainders over upon termination, to the issue of the daughters under certain conditions, otherwise to five charities (R. 115).

Neither the will nor the decree of final distribution mentioned "depletion," the apportionment of anything "between the income beneficiaries and the trustee," the protection or preservation of corpus, nor the establishment of a depletion reserve to protect the remaindermen.

While both the will and the decree of final distribution expressly authorized the trustees to lease property (R. 115) neither the will nor the decree expressly authorized a lease for a period beyond the termination of the trust, nor any lease or agreement for the extraction of oil and gas. All net oil royalty income without any allowance or deduction for depletion was distributed by the trustees to the widow prior to her death in 1945, and thereafter and prior to November 1, 1951 to the two daughters in equal shares (R. 118-9).

Early in 1948 oil was discovered near certain mineral interests owned by the trust (R. 118) which had a nominal value when Sloan died.[3] An agreement for the development and extraction of oil and gas was entered into

[3]The Trustee also received other royalties; inasmuch as they account for less than 3% of the total royalties received in each of the tax years involved in this case, no factual statement is made in respect to them.

between the trustees and Richfield Oil Corporation in 1948 (R. 118-9): The agreement by its terms might have extended beyond the term of the trust. The agreement required the trustees to obtain a construction or modification of the decree of final distribution in a court of competent jurisdiction to determine the authority of the trustees to make the agreement (R. 119). The trustees sought such determination in connection with their nineteenth account and report and petition for instructions in the California court having jurisdiction of the trust (R. 120).

The California court, Honorable A. J. Woolsey, Judge, presiding, on May 19, 1953, entered its decree (exhibit 26),[3a] finding that at the time of the testator's death the mineral interests subject to the Richfield agreement had only a nominal value (finding 17, exhibit 26, p. 19); a favorable agreement could not be made if the trustees had no power to make the agreement, whether for a period extending beyond the termination of the trust, or otherwise (finding 22, exhibit 26, p. 21); the trustees had the power and authority to make the Richfield agreement, provided the royalty income produced from the mineral rights be allocated between the present income beneficiaries and the trustees as in the decree provided (finding 28, exhibit 26, p. 26); that from and after November 1, 1951, 72½% of the gross Richfield royalties, subject to and after payment of all necessary and proper expenses under the Richfield agreement and under the decree of final distribution, was allocated to the present

[3a] All references to exhibits are to those in evidence before the Tax Court.

income beneficiaries, and 27½% of the gross Richfield royalties, subject to and after payment of all such expenses, were allocated to the trustees (finding 39, exhibit 26, pp. 31-2). The decree followed the findings in respect to the authority to execute the Richfield agreement and in respect to the allocation of the royalty income thereunder.

Nowhere in the California court's decree is any mention made of depletion, of any depletion allowance, of the allowable deduction for depletion, of the protection or preservation of corpus, of a reserve for depletion, of keeping corpus intact, of "return of capital" or of "return of corpus." The decree uses the word "corpus" three times.[4]

There was no pleading before, no evidence before, no finding by and no determination by, the California court that "the present value of the corpus" or the value of the corpus at the time of the hearing before the California court in 1952-53 was to be preserved.

The California court's decree settling the 21st account and report determined that the allocation of the total distributable and retained income for the calendar year 1952 and the allocation of the necessary costs and expenses and of other deductions permitted for state and federal income tax purposes shown by such account and report, including the payment of federal income taxes in excess of $55,000, was just and fair and in accordance

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[4]Once, in speaking of "securities forming part of the corpus" (finding 49, exhibit 26, p. 34), and twice in speaking of unborn remaindermen who may have "rights to participate in the corpus or income . . ." (finding 58, exhibit 26, p. 37; decree, parag. 3, exhibit 26, p. 40).

with the decree of May 19, 1953 (exhibit 29, decree p. 8, line 20-p. 9, line 1) and ratified and approved the account and report (exhibit 29). The same is true of the decree settling the 22nd account and report for the year 1953 (exhibit 30, pp. 5-6).[5]

Petitioners and the trustees filed their respective income tax returns for 1952 and 1953 showing the allocation of income in accordance with said decree and claimed a deduction of 27½% of the gross royalty income allocated to each, respectively.

Respondent assessed a deficiency against petitioners disallowing them any deduction for depletion "because under the provisions of section 23(m) of the Internal Revenue Code of 1939, if the trustees in determining the distributable income are to make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable depletion deduction can be taken solely by the trustees." (R. 36, 38, 75) The net effect was not only to deprive the income beneficiaries of all depletion, but leaving unused by the trustees over $14,000 of depletion in 1952, and over $44,000 in 1953.[6]

Taxpayers filed timely petitions in the Tax Court to redetermine such deficiencies. The Tax Court sustained

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[5]The 23rd, 24th and 25th accounts and reports and the decrees settling the same with similar determinations were excluded from evidence as not having any probative value in this case (R. 213-4).

[6]Query, will the Commissioner contend in respect to the trustees that they are limited to 50% of the net income from the property, thus leaving unused depletion of $77,894.94 in 1952, and $76,146.92 in 1953? (See Section 114(b)(3) of Internal Revenue Code of 1939, App. p. 17.)

respondent's determination, citing its own decision in *Estate of Mary Jane Little*, 30 TC 936. The petitioners perfected petitions for review in the United States Court of Appeals for the Ninth Circuit, pursuant to Sections 7482 and 7483 of the Internal Revenue Code of 1954.

The Court of Appeals, conceding that the Tax Court's reliance on the *Estate of Mary Jane Little*, supra, was misplaced because it had been reversed by the Ninth Circuit (274 F. 2nd 718), affirmed the judgment of the Tax Court.

A timely petition for rehearing was filed and denied on December 19, 1960.

On December 14, 1960, after the filing of the petition for rehearing, but before the denial thereof, the surviving trustee filed in the California court its 28th account and report and petition for advice in relation to its decree of May 19, 1953, and particularly as it was interpreted by the Court of Appeals in its present opinion. Thereafter on January 11, 1961, the California court, the decree being signed by the very judge who signed the decree of May 19, 1953, entered its decree, in effect repudiating the Court of Appeals opinion insofar as the law of California and the decree of May 19, 1953 are applicable.[6a] This decree is not yet final. It determined that the retention of royalty income was not intended to preserve corpus, but was ancillary to the approval of the execution of the Richfield agreement which might extend beyond the term of the trust after the death of either daughter, and that such approval and retention was based on the

[6a]Portions of said decree are printed in the appendix hereto, pp. 24-41.

equitable powers of the state court, and not on a construction of the will.

On January 17, 1961, because of the entry of the California court's decree of January 11, 1961, a motion for leave to file a second petition for rehearing and for reconsideration was filed in the Court of Appeals. Attached to the motion was a copy of the proposed second petition for rehearing, with the California court's decree of January 11, 1961 attached thereto. Leave to file the second petition for rehearing was denied on January 26, 1961.

On February 27, 1961 the order of January 26, 1961 was vacated, the motion for leave to file the second petition for rehearing and for reconsideration was granted, and said second petition for rehearing was filed; on March 10, 1961 the second petition for rehearing was denied.

REASONS FOR GRANTING THE WRIT

1. INTRA CIRCUIT CONFLICTS.

There is a direct conflict on two distinct grounds with an earlier 1960 decision of another panel of the same court in *Little's Estate* vs *Commissioner*, 274 F.2nd, 718: (a) The present decision holds that "there are pertinent provisions of the will . . . disposing of depletion allowances" (Appendix p. 10) presumably because the only things the trustees "were authorized to distribute were 'rents, issues, profits and income'." (Appendix p. 7) while the will in the *Little* case "contained no pertinent provision apportioning the allowable deductions for depletion . . ." (274 F.2nd at 729) notwithstanding that the only thing, with an

exception not here material, the trustees were authorized to distribute was net income (274 F.2nd at 721). Any attempted distinction of the *Little* case on the ground of a limited discretion (*First National, etc.* vs *Howard* [Sup. Ct. Texas, 1950] 229 SW 2nd 781, 783) to determine what is corpus and what is income is unsound because the distinction is based on no fundamental difference in determining whether there are pertinent provisions of the will apportioning the allowable deduction for depletion between the income beneficiaries and the trustees. (b) The present opinion repeatedly refers to the decree and frequently couples it with the will, while in *Little* the other panel having held that the testamentary trust was created by the will, deemed it unnecessary to discuss the later state court decree since "such decree could not affect the application of the plain provision of" Section 23(m), (274 F. 2nd at 729).

Whether the decision below is right or wrong, the conflicts should be resolved by this court granting certiorari as it has in other cases of intra circuit conflicts. See *Dickinson* vs *Petroleum Conversion Corp.* 338 U.S. 507, 70 S.Ct. 322; *Compagnie Generale Transatlantique* vs *Elting*, 298 U.S. 217, 56 S.Ct. 770; *U.S. ex rel Robinson* vs *Johnston*, 316 U.S. 649, 62 S.Ct. 1301.

2. IMPORTANT QUESTIONS OF FEDERAL LAW.

(a) Whether the mere direction in a will or other trust instrument to pay out income or net income is a pertinent provision within the meaning of Section 23(m) requiring that all depletion be allocated to the trustee is of widespread importance. Every trust holding depletable assets, where there is a direction to pay out income or all net income is affected. There are many such trusts.[7] This question has never been, but should be, determined by this Court. As the court below has answered the question, all income beneficiaries of trusts governed by the Texas Trust Act[8] and similar state statutes or common law rules of trusts requiring similar allocation, would be deprived of all depletion deductions. Thus the question is a matter of general importance not limited to this case alone, or to a handful of people. Similarly, whether a subsequent decree

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[7] In the following cases the will directed payment of "all income" or all "net income":

Blair vs *Commissioner* (1937) 300 U.S. 5, at p. 7;
Freuler vs *Helvering* (1934) 291 U.S. 35, at p. 36;
Merle-Smith vs *Commissioner* (CA 2 [1930]) 42 F. 2nd 837 at p. 838-9;
Estate of Little vs *Commissioner* (CA 9 [1960]) 274 F. 2nd 718;
Upton vs *Commissioner*, supra.

Space forbids mention of more of a long list that could be cited.

[8] On January 13, 1955, The First National Bank in Dallas in a request for ruling wrote the Commissioner, in part saying:

"This bank maintains and operates one of the largest trust departments in the Southwest—an area in which natural resources, particularly oil and gas, are prominent among assets held in trust. Accordingly, whether such deduction allowable for income tax purposes should be apportioned between the beneficiaries of the trust and the trust itself or if apportionable, how the apportionment shall be made, is important and frequently encountered. Unfortunately, the trust instrument rarely adequately defines net income or distributable income, and almost always is silent respecting the manner in which the deduction for depletion shall be treated as between the beneficiaries and the trustee."

of a state court has any effect upon the application of Section 23(m) or its successor under the 1954 Code would affect trust administration in a substantial area of the United States.

(b) The decision below will foment and sustain administrative confusion as the Commissioner's policy in this area has been inconsistent and uncertain. The Internal Revenue Service ruled in 1955 that the Texas Trust Act, which required the trustees to retain 27½% of the oil royalties in the absence of a contrary provision in the trust instrument, constituted only a direction to allocate income and did not constitute a pertinent provision requiring allocation of the depletion deduction to the trust. (Letter ruling dated April 6, 1955 addressed to First National Bank in Dallas) This ruling was revoked in 1957 when the Internal Revenue Service took the precisely opposite view. (Letter ruling dated January 31, 1957 addressed to First National Bank in Dallas) It should also be noted that percentage depletion was allowed without question to the income beneficiaries of the Sloan trust on oil royalties aggregating over $1,000,000 paid them from 1943 to 1951, both inclusive.

(c) Whether Sloan's "will provides that the trustees in determining the distributable royalties shall first make due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose" (appendix p. 9) is not an important question of general application. Whether any court can read words into a will or other instrument is an important question of general application. Thus, the court below read into the will the underscored portion of the following:

The trustees shall receive the rents, issues, profits and income of said property, and after paying all necessary and proper expenses incurred by them in the administration of their trust and after making due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose (appendix p. 9) shall dispose of the net rents, issues, profits and income of said property as directed.

(d) Regardless of whether the decision below is right or wrong, whether regulations adopted long after the testator's death can require a provision of any will to "be interpreted as a direction" from such a testator "that all depletion allowances be granted to the trustees," (appendix p. 10) thereby losing some of such allowances is a question of general importance. No subsequent statute, regulation or tax situation can affect, much less change, the direction of a long deceased testator.

(e) The decision below construes Section 23(m) and a provision in the instrument creating a trust to pay out net income as depriving income beneficiaries of all depletion on millions of dollars of royalty income to preserve a corpus of nominal value at the time of the creation of the trust. Such construction is unreasonable. Regardless of whether the decision below is right or wrong, the question of reasonable construction is universal.

(f) The question is one of continuing importance in the administration of the internal revenue laws, under the Internal Revenue Code of 1954 as well as its predecessors, and may be expected to recur until authoritatively settled by this Court.

3. CONFLICTS WITH APPLICABLE DECISIONS OF THIS COURT.

(a) The Court below decided a question of federal law in conflict with applicable decisions of this Court in *Freuler* vs *Helvering* (1934) 291 U.S. 35, reversing CA 9th, 62 F. 2nd 733 and *Blair* vs *Commissioner* (1937) 300 U.S. 5, reversing CA 7th, 83 F. 2nd 655. Both of these decisions of this Court hold that insofar as the question is one of state law, a state court decree interpreting the state law in direct relation to the particular trust is binding on the Tax Court and the Court of Appeals.

The court below in holding that the California court determined that the testator intended a portion of the royalty income to be return of capital or preservation of corpus conflicts with the state court's determination in the decree of May 19, 1953 that there was no authority in the will to execute the Richfield agreement which was necessary to prevent loss by drainage; that the court had equitable powers to authorize said agreement and in exercise of those powers it could and did require an allocation of the royalty income. The decrees settling the 21st and 22nd accounts also showed the consistent construction of that decree by the California court in accordance with petitioners' contentions.

The conflict is compounded when the court below refused to "go behind" a non-existent determination by the California court "that the present value" of the corpus is to be preserved. In reaching such specious conclusion, the court below ignored the fact that there was no evidence whatever before, or finding by, the California court as to "present value."

Finally, if there were any doubt it has been erased by the decree of January 11, 1961 (appendix pp. 24 to 41) which spells out in no uncertain terms that the court below was plainly wrong in interpreting California law in direct relation to this trust.

While that decision is not yet final this Court has said that the decision of a California court of competent jurisdiction "until reversed or overruled, establishes the law of California respecting distribution of the trust" income in respect to that trust. (*Freuler* vs. *Helvering* [1934] 291 U.S. 35, at p. 45), and that "the supervening decision of the state court interpreting that law in direct relation to this trust cannot justly be ignored . . ." (*Blair* vs *Commissioner* [1937] 300 U.S. 5 at p. 9)

(b) "The Revenue Act of 1928, §23(l), 45 Stat. 800 (26 USCA §2023(l)), authorizing a deduction for depletion, seems to be declaratory of existing law and specifically allows deductions in such computations to be apportioned between the income of beneficiaries and trustee in accordance with the provisions of the instrument creating a trust." (*Merle-Smith* vs *Commissioner* (CA 2 [1930] 42 F. 2nd 837 at p. 842)[9] If that be true, then the decision below is in direct conflict with the decisions of this Court in *Reynolds* vs *Cooper* (1934) 291 U.S. 192 involving oil royalties, and in *Helvering* vs *Falk* (1934) 291 U.S. 183 involving iron ore royalties, each of which held that income beneficiaries of trusts were entitled to all depletion

[9]In one of the trusts in this case "provisions were made for taxes and expenses in preserving the corpus of the trust" and for payment "of the net annual income" (42 F. 2nd at p. 839)

on royalty income for the calendar years 1923 to 1927 under the Revenue Acts of 1921, 1924 and 1926.

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4. CONFLICTS WITH THE DECREES OF THE CALIFORNIA COURT IN DIRECT RELATION TO THIS PARTICULAR TRUST.

To the extent that California law is determinative of any material point in the controversy there is a direct conflict between the decision of the court below and the California law as determined by the California court having jurisdiction of the trust in four different decrees, namely the decree of May 19, 1953, the decrees settling the 21st and 22nd accounts, and the decree of January 11, 1961. Such conflicts are presented in 3(a) above.

CONCLUSION

Regardless of whether the decision below is right or wrong, a construction of Section 23(m) by this Court is needed. There are obvious recent intra circuit conflicts, conflicts with applicable decisions of this Court and conflicts with the California court. This is a proper case for certiorari. To the extent California law is determinative of any material point in the controversy, certiorari is a means to end an unseemly dispute between the state court and the court below on questions of California law.

Dated at San Francisco, California,
March 17, 1961.

EVERETT S. LAYMAN,
Attorney for Petitioners.

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APPENDIX TO PETITION FOR WRIT OF CERTIORARI to the United States Court of Appeals for the Ninth Circuit

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Appendix

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JOHN R. UPTON, ANNA L. S. UPTON and MARGARET ST. AUBYN, *Petitioners;* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 16,703 Sept. 27, 1960

Petitions to Review Decisions of the Tax Court of the United States

Before: CHAMBERS and HAMLEY, Circuit Judges, and FOLEY, District Judge

HAMLEY, Circuit Judge:

The named petitioners seek reversal of two decisions of the Tax Court rendered in consolidated proceedings to redetermine tax deficiencies and reported in 32 T. C. 301. The principal question presented here relates to the apportionment of percentage depletion allowances as between the life beneficiaries and the trustees of a testamentary trust in computing federal income taxes on oil well royalties.

The testator, William R. Sloan, died on April 14, 1923, leaving his widow, Agnes G. Sloan, and two daughters, Anna L. Sloan (now Upton) and Margaret R. Sloan (now St. Aubyn). The two daughters, Anna and Margaret, and Anna's husband with whom she filed joint returns are the petitioners here.

Most of Sloan's estate was distributed to trustees named in his will. They were directed to receive the rents, issues, profits and income of the property and to dispose of the same as provided in the will after paying necessary and proper expenses. Sloan's

sister-in-law, Anna M. Kiernan, was to receive twenty-five dollars a month as long as she lived, and the widow was to receive the rest of the net income as long as she lived. Upon the death of the widow and her sister all of such net income would go to the daughters, if then living, in equal shares.

Provision was made for the termination of the trust as to one-half of the corpus if and when either daughter died leaving issue. This share of the corpus would then go to the living issue of the deceased daughter in equal shares. In the event of the death of a daughter leaving no issue no part of the trust would terminate, but the surviving daughter would be the sole income beneficiary. Upon the death of the surviving daughter the entire trust would terminate. If the surviving daughter left living issue they would receive the corpus in equal shares. If there were no living issue the corpus would go to five named charities.

The trustees had no power under the will to distribute anything to the life beneficiaries except "rents, issues, profits and income," after deducting therefrom necessary expenses of administration. The trustees were given power to sell trust property. However, they were required in that event to invest and reinvest the proceeds, or to purchase or acquire other property, all of which was to be held upon the same uses and trusts as the original trust property.

Anna M. Kiernan died on January 14, 1936, and Agnes G. Sloan died on December 26, 1945. Since the latter date the two daughters have been entitled to all of the net income of the trust. Children were born to each of the daughters, and these children are now living.

Among the assets which were distributed to the trustees were 107 shares of the stock in Pleasant Valley Farming Company, then appraised at $32,100. About nineteen years later, on April 23, 1943, this company distributed to its shareholders economic interests in oil and gas in place. The fair market value of the economic interests so distributed to the trustees at this time was $46,101.08. The bulk of these economic interests consisted of an interest in oil-producing lands leased to the Standard Oil Company of California. Between 1943 and October 31, 1951, net royalties received by the trustees from these interests aggregated $121,007.44.

Until the death of the widow on December 26, 1945, all such royalties were distributed to her. Thereafter the net royalties were distributed to Anna and Margaret. Depletion in an aggregate of $33,991.39 (27½% of $123,605.03, the gross royalties) was claimed as a deduction by the distributees, the mother and daughters, in computing their respective federal income taxes for the years 1943 to October 31, 1951. No depletion was claimed by the trust prior to November 1, 1951.

Beginning on that date the trustees, for the reasons stated below, retained 27½% of the Pleasant Valley royalties and took a 27½% depletion allowance on the royalties so retained. In November and December 1951 the sisters took no depletion allowance on the 72½% of Pleasant Valley royalties which were distributed to them beginning on that date. Beginning on January 1, 1952, however, they did take a 27½% depletion allowance on royalties thereafter received.

Among the other assets which were distributed to the trustees were the mineral rights in certain lands in Cuyama Valley, San Luis Obispo County, California. These mineral interests were not separately described or referred to in the inventory or decree of final distribution, and were distributed to the trustees by the so-called omnibus clause of that decree. The fair market value on April 14, 1943, of the oil, gas and other hydrocarbons covered by these mineral interests was $5,445.25.

Early in 1948 oil was discovered in the Cuyama Valley. About June 19 of that year the trustees entered into a written agreement with Richfield Oil Company for the development of oil and gas from the mineral interests held by the trust in this valley. A provision in this agreement required the trustees to obtain a court determination of their right to enter into the agreement. For the purpose of obtaining such a determination the trustees instituted a declaratory judgment suit in the Superior Court of the State of California in and for the County of Alameda.

At the outset of this action a question arose as to whether the royalties should be retained by the trustees and only the income thereof be distributed to the sisters. Since this question could not be determined in the declaratory judgment action, that suit was abandoned. The trustees then filed their 19th report and

account in the trust proceeding before the Alameda County Superior Court and asked for instructions as to the authority to enter into the Richfield agreement. They also asked for instructions as to the distribution of the royalties under both the Richfield agreement and the Standard Oil lease.

In the petition for instructions the trustees took the position that all of the royalties should be distributed to Anna and Margaret, and that none should be retained by the trustees. In an answer filed by the sisters the same position was taken. In objections filed by the guardian ad litem for living and unborn remaindermen, however, the position was taken that all the royalties should be retained by the trustees and only the income thereof distributed.

After a hearing which extended over four days a decree was entered on May 19, 1953, confirming the authority of the trustees to enter into the Richfield agreement.[1] The trustees were instructed to allocate 72½% of the royalty income from the Richfield agreement and the Standard Oil lease to the sisters and to allocate the balance to the trustees. The 27½% of the royalties thus allocated to the trustees was referred to in the decree as "retained royalties."

It was further provided that all such retained royalties should be invested and reinvested, the income therefrom to be currently distributed to the income beneficiaries in equal shares. For purposes of distribution of the corpus of the trust upon termination of all or a part of the trust it was ordered that retained royalties "be treated in all respects as if it were part of the property distributed to the trustees by said decree of final distribu-

[1] In this connection it is recited in the decree:

"28. The surviving trustees do, and did, have the power and authority to execute the Richfield agreement and any other lease or other agreement for the exploration for, and the production and sale of, oil, gas and other hydrocarbons in, under or from the trust properties above described, even though such properties are in the nature of wasting assets, provided that the royalty income produced from the mineral rights subject to the Richfield agreement as amended or from the interests subject to such other lease or other agreement be reasonably apportioned or allocated between the present income beneficiaries and the trustees as hereinafter in this decree provided . . . ."

tion . . . ." The trustees were directed to establish two additional accounts, namely, the retained royalties account and the income from retained royalties account.[2]

In computing net income in their fiduciary income tax returns for 1952 and 1953 the trustees deducted 27½% of the royalties which they had retained as depletion allowance authorized by section 114(b)(3) of the Internal Revenue Code of 1939, 26 U.S.C.A. Likewise and for the same reason, in computing net income in their personal income tax returns for those years petitioners deducted 27½% of the royalties which had been distributed to them. The Alameda County court was advised of this in the 21st and 22nd accounts and reports filed by the trustees for the calendar years 1952 and 1953. These accounts and reports were approved by that court.

Upon examination of the tax returns filed for those years the Commissioner of Internal Revenue determined that the income beneficiaries were not entitled to take credit for any depletion allowance on such distributed royalties, and that the trustees should have taken credit for all of it. Readjusting the returns to reflect this determination, the Commissioner notified the Uptons that their income tax payments were deficient in the amount of $36,155.48 for 1952, and $29,373.87 for 1953. Likewise, Mrs. St. Aubyn was notified that her income tax payments were deficient in the amount of $42,047.43 for 1952, and $38,516.12 for 1953.

Adherence to this determination by the Tax Court led to the filing of the petition for review now before us. In the meantime, and as a protective measure pending the outcome of this litigation, the trustees have filed claims for refund for 1952 and 1953.

The apportionment of the depletion allowance as between the income beneficiaries and the trustees of a trust is governed in

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[2] No motion for a new trial was made and no appeal was taken from the decree of May 19, 1953. Gross royalties in the amount of $492,336.86 were received in 1952. The trustees distributed 72½% of this sum, or $356,944.22 to the sisters in equal shares. The trustees retained the remaining 27½%, or $135,392.64, as provided in the decree. On the same basis royalties in the amount of $285,401.67 were distributed in 1953, and the remaining $108,255.80 for that year was retained by the trustees.

this case by section 23(m) of the Internal Revenue Code of 1939, 26 U.S.C.A. The applicable part of this section reads as follows:

> ". . . In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

Petitioners take the position that there are no pertinent provisions of the trust instrument which apportion depletion allowance between the income beneficiaries and the trustees. Therefore, it is argued, the last clause of section 23(m), which governs when there are no such pertinent provisions, must be given effect. It is asserted that this is what they and the trustees did, since they apportioned depletion allowances between themselves on the same basis as the court in its decree of May 19, 1953, had allocated royalties.

The Commissioner, on the other hand, takes the position that there are pertinent provisions in the trust instrument whereby all depletion allowances were granted to the trustees. Proceeding on this premise, the Commissioner reasons that there is no occasion for applying the last clause of section 23(m) which governs only when there were no such pertinent provisions. The Tax Court is in full accord with this view.

Petitioners and the Commissioner are in agreement that the "instrument creating the trust," as those words are used in section 23(m), is the will of William R. Sloan. They are also agreed that there is no provision in that will which in express terms grants all depletion allowances to the trustees or apportions them between the income beneficiaries and the trustees. The will does not use the word "depletion" and does not expressly provide for the apportionment or allocation of anything for income tax purposes.

There is nothing in section 23(m), however, to indicate that an apportionment of depletion allowances as therein referred to must be stated in express terms. As in the case of any other term or condition of a trust instrument, if the intention of the trustor can be determined from an examination of the pertinent provisions of the instrument that intention will be given effect

whether or not stated in express terms. See Commissioner v. Netcher, 7 Cir., 143 F.2d 484, where a similar statutory provision relating to depreciation rather than depletion was under consideration.

It is this principle which the Commissioner relied upon in giving notice of the deficiencies, and which he now relies upon in defending the Tax Court's decisions. In substance the Commissioner argues that (1) the will provides that the trustees in determining the distributable royalties shall first make due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose; and (2) when a will contains such a provision this evidences an intention on the part of the testator that the depletion allowances be not apportioned between income beneficiaries and trustees, but that it be granted in full to the trustees. The petitioners take issue with both of these contentions.

With regard to the first of these contentions, we think that the will required the trustees to preserve the corpus. This necessarily follows from the fact that the only things they were authorized to distribute were "rents, issues, profits and income." But whether the testator intended to include all oil well royalties under "income", as that term is used in the will, or intended to consider part of such royalties as corpus is another question.

As we see it, however, this latter question has been settled by the state court decree of May 19, 1953. The petition for advice and instructions filed by the trustees in that proceeding framed the question as follows:

> ". . . whether such royalties are income to be distributed to the life beneficiaries of the respective trusts or whether all or some part of such royalties are a return of capital and should in whole or in part be held as part of the principal of the trust, and if so, the extent to which they are income and to which they are principal."

The trustees took the position in that petition that the royalties were income to be distributed currently to the life beneficiaries and that no part thereof was principal. Anna and Margaret, the life beneficiaries, in their responsive pleading made the same

answer to the same question.[3] The guardian ad litem for the remaindermen in their objection to the 19th account and report contended that all of the royalties were principal of the trust and were not to be distributed currently as income to the life beneficiaries. All parties were in agreement that the answer to the question required the court to ascertain the intention of the testator.

The Alameda County court answered this question in its decree of May 19, 1953, by instructing the trustees to allocate 72½% of the royalties to Anna and Margaret, and to allocate 27½% to themselves as "retained royalties."

In the decree no reasons are stated for directing this allocation, and the royalties to be retained by the trustees are nowhere referred to as return of capital. The conclusion is nevertheless inescapable that the trustees were ordred to retain the 27½% on the theory that the testator intended this portion of the royalties to represent return of capital.

This is the only basis on which the court was asked to require such a retention. Petitioners do not suggest any other theory on which the court could have ordered a retention of royalties, since the will required that all net income be distributed to the life beneficiaries. It is also significant that the decree of the Alameda County court contains no provision for the retention of any trust income except for part of the oil well royalties.

There are other circumstances which lead to the same conclusion. In its decree the state court referred to the royalties as derived from "wasting assets" and therefore conditioned the authority of the trustees to enter into the agreement with Richfield upon retention of part of those royalties. The decree requires that the income from retained royalties be currently distributed to

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[3]At the outset of the hearing counsel for the life beneficiaries, who are the petitioners here, stated the question in these words:

> "The question has been raised whether such royalties are income to be distributed to the life beneficiaries of the respective trusts or whether all or some part of such royalties are a return of capital and should in whole or in part be held as part of the principal of the trust, and if so, the extent to which they are income and to which they are principal."

the life beneficiaries as in the case of income from any other asset of the trust. The decree also provides that upon termination of the trust retained royalties and investments derived therefrom be distributed as corpus of the trust. Moreover, the percentage of royalties ordered to be retained conforms exactly with the percentage depletion allowance available under section 114(b)(3), which allowance itself is designed to preserve the value of a wasting asset.

It is true that in subsequent annual accounts and reports depletion allowance was apportioned between the life beneficiaries, and this allocation was approved by the state court. From this petitioners argue that the state court has construed its decree of May 19, 1953, as effectuating only an allocation of "income" as that term is used in the will.

In these subsequent proceedings, however, the only issue was the approval of the trustees' account. Since the proceedings were nonadversary in character and no issue was drawn as to the terms of the prior decree, the order of approval cannot be regarded as constituting adjudications of the meaning of the 1953 decree. Apart from this, these subsequent decrees, whether or not adversary in character, could have no significance here since the distribution of depletion allowance is to be determined by the federal criterion provided by section 23(m). As to the application of a federal criterion in a particular case the Tax Court is not bound by state court decisions. See Gallagher v. Smith, 3 Cir., 223 F.2d 218, 222.

It is therefore our conclusion that the will provides that the trustees in determining the distributable royalties shall first make due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose. The state court has fixed this amount at 27½%.

This brings us to the second contention on which the Commissioner's case is based. As stated above, this contention is that when a will contains a provision requiring the trustees to conserve corpus this evidences an intention on the part of the testator that the depletion allowance be granted in full to the trustees.

In support of this contention the Commissioner cites administrative regulations, legislative history, and Commissioner v.

Netcher, 7 Cir., 143 F.2d 484. The regulations relied upon are Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939, sections 39.23(l)-1 and 39.23(m)-1(c). These regulations were originally promulgated in 1928 and have been in effect for over thirty years without change.

Section 39.23(l)-1 relates to depreciation, and after using the language of section 23(m) of the Internal Revenue Code of 1939 goes on to explain that section as follows:

> ". . . for example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee."

Section 39.23(m)-1(c) relates to depletion and provides in part:

> "The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion."[4]

These regulations not only sanction but require that a provision of a trust instrument placing a duty upon the trustee to retain part of oil well royalties as return of capital be interpreted as a direction from the trustor that all depletion allowances be granted to the trustees. Giving effect to these regulations, therefore, it must be held that there are pertinent provisions of the will so disposing of depletion allowances. It follows that the last clause of section 23(m), which governs only where there are no such provisions in the will, has no application in this case. See Com-

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[4]The quoted regulations, having been in effect through many sessions of Congress in which the tax statutes were dealt with, have the force and effect of law. Crane v. Commissioner, 331 U. S. 1.

missioner v. Netcher, supra, dealing with similar statutory language relating to depreciation.[5]

Despite all that is stated above, however, this court could not, except in en banc proceedings, hold in favor of the Commissioner if in another case this court has reached a contrary result in deciding the same question. Petitioners argue that there is such a decision of this court, citing Estate of Little, 9 Cir., 274 F.2d 718.

In Little, as in this case, the will which created the testamentary trust made no express mention of the treatment of the depletion deduction. The trustees retained 27½% of the royalties and took credit for all of the depletion allowance in computing fiduciary

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[5]The wording of section 39.23(l)-1 of the regulations is almost identical with language contained in the reports of committees of Congress when the forerunner of section 23(m) was under consideration. Section 23(m) of the Internal Revenue Code of 1939 was first enacted in 1928. Act of May 29, 1928, 45 Stat. 791-883. It was then designated as section 23(l) and was preceded by section 23(k) dealing with depreciation, containing similar language. By the Act of May 10, 1934, 48 Stat. 680-772, sections 23(k) and (l) became sections 23(l) and (m), respectively. They are so designated in the Internal Revenue Code of 1939.

The purpose of adding to the internal revenue laws these new provisions relating to depreciation and depletion was explained in the report of the Senate Committee on Finance reporting the Internal Revenue Bill of 1928 to the Senate. S.Rep. No. 960, 70th. Cong., 1st Sess. (1928) p. 20; (1939-1 Cum.Bull. (Part 2) 409, 423). After first stating in substance the new statutory language the report continues:

> "For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. The bill contains similar provisions as to the deduction for depletion."

Like language was also used in the conference report on that bill. H.Conf.Rep. No. 1882, 70th Cong., 1st Sess. (1928), pp. 11-12 (1939-1 Cum.Bull. (Part 2) 444, 445). See also, Carol v. Commissioner, 30 B.T.A. 443, 447.

tax returns. The income beneficiary in computing her tax returns took credit to the amount of royalty income she had received.

The Commissioner approved the action of the trustees and disapproved that of the beneficiary. Tax deficiencies were charged against the estate of the beneficiaries, which were sustained by the Tax Court. 30 T. C. 936. This court reversed, holding that since the will made no mention of the treatment of the depletion deduction, depletion allowance was to be apportioned on the basis of the trust income allocable to each as provided in the last clause of section 23(m).

In our opinion there is a major factual difference between the two cases which deprives Little of precedent value here. In this case the Sloan will as construed by the state court in its decree of May 19, 1953, required the trustees to retain part of the royalties as return of corpus. This being a direction by the testator, the inference arose therefrom that he also intended them to take the entire depletion allowance. This is established by the administrative regulations, legislative history, and Netcher case, all discussed above.

In the Little case the will did not require the trustees to retain part of the royalties as return of corpus. While they chose to do so in the exercise of discretion vested in them, this could not be regarded as a direction by the testator. Hence the fact that they voluntarily withheld some royalty as return of capital could not give rise to an inference that the testator intended them to take credit for all of the depletion allowance. There being no express or implied direction to that effect, it was necessary to give application to the last clause of section 23(m) providing that in the absence of any such direction depletion allowance shall be apportioned on the basis of the trust income allocable to each.

Petitioners are correct in asserting that in the instant case the Tax Court's reliance upon its decision in Mary Jane Little, 30 T. C. 936, was misplaced. Since that decision was reversed, it does not support the Tax Court's decision here under review. Nevertheless and for the reasons stated above, we believe that the reversal in Little does not require a like result here.

It is pointed out by petitioners that in Little this court found it unnecessary to discuss a decree entered by a Texas state court.

We there stated that ". . . in our view such decree could not affect the application of the plain provisions of sections 23(l) and (m) to the relevant facts before us." (page 729)

In the Texas proceeding that state court was asked to determine the meaning of the term "net income" as used in the will. As already noted, the will involved in Little did not require the trustees to retain part of the royalties as return of capital, but gave the trustees complete discretion in this regard. However, this discretionary power was given up by the trustees in a subsequent settlement agreement among the interested parties. This agreement was recognized and considered by the Texas court in its decree. But this court disregarded that agreement for the purposes of determining the federal income tax question.

Thus, the Texas court was not construing the will alone but was interpreting it in conjunction with a subsequent agreement which was irrelevant for federal income tax purposes. Considered in this light, our decision in Little does not represent a ruling that this court would disregard a state court decree construing the will.

We do not consider ourselves free to construe the Sloan will de novo, the Alameda County court having already construed it as requiring the trustees to retain part of the royalties. This construction did not reflect the application of state law where the will contains no pertinent provisions, but a determination from a reading of the will as a whole that this is what the testator intended.

Petitioners also argue that there was no real corpus to preserve, since the value of the part of the trust property from which royalties were later derived was nominal when the property was distributed to the trust. The Alameda County court apparently proceeded on the theory that the present value of the corpus is to be preserved. We will not go behind that determination.

We hold that under pertinent provisions of the will all of the depletion allowances were granted to the trustees.

We find no prejudicial error in the exclusion of certain exhibits consisting of the trustees' accounts and reports for three subsequent years together with the decrees settling them, and a

summary of royalties received and allocated over a number of years.

Affirmed.

(Endorsed) Opinion Filed Sept. 27, 1960.

Frank H. Schmid, Clerk.

United States Court of Appeals
for the Ninth Circuit

John R. Upton, Anna L. S. Upton and Margaret St. Aubyn, Petitioners, vs. Commissioner of Internal Revenue, Respondent.	No. 16703

JUDGMENT

Petitions to Review Decisions of the Tax Court of the United States.

This cause came on to be heard on the Transcript of Record from the Tax Court of the United States, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the Decisions of the said Tax Court of the United States in this cause be, and each of them hereby is affirmed.

(Endorsed) Judgment

Filed and entered: September 27, 1960

Frank H. Schmid, Clerk.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939

Sec. 23. In computing net income there shall be allowed as deductions:

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. . . . In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. . . . In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b) (3) and (4).

Sec. 114(b)(1)

General Rule—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted

basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3) and (4) of this subsection.

Sec. 114(b)(3). Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect to the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

Regulations 118

§ 39.23(m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.* (a) Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

(b) Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. However, no depletion deduction shall be allowed the owner with respect to any timber or coal which such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber or coal, if such disposal is considered a sale of timber or coal under section 117 (k) (2). An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner

of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

(c) The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (Remaining subparagraphs omitted as immaterial.)

§ 39.23(m)-2 Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion. (a) The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided for in section 113(a), adjusted as provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except that the amount of expenditures treated as deferred expenses under sections 23 (cc) (2) and 23 (ff) (2) shall be disregarded in determining such adjusted basis (see §§ 39.113(a)-1 to 39.114-1, inclusive, and §§ 39.23(cc)-1 and 39.23(ff)-1); and if the amount of the basis as adjusted applicable to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by

the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

§ 39.23(m)-4 Computation of depletion based on a percentage of income in case of oil and gas wells. Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see § 39.23(m)-1 (e) and (g).) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113. [Reg. 118, § 39.23(m)-4.]

§ 39.23(m)-7 Determination of fair market value of mineral properties, including oil and gas properties. (a) If the fair market value of the property at a specified date is to be determined for the purpose of ascertaining the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision

by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of simmar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of a capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight (1) if the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer or to extrinsic causes other than the possession of the min-

eral itself. If the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method.

§ 39.23(m)-8 Revaluation of mineral deposits not allowed. No revaluation of a property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of a subsequent discovery of nonmetallic minerals in respect to which depletion is not allowed on the basis of percentage of income under § 39.23(m)-4 or § 39.23(m)-5, or of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The value should, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation. The value should be redistributed:

(a) If a revision of the number of remaining recoverable units of mineral in the property has been made in accordance with section 23(m) and § 39.23(m)-9, and

(b) In the case of the sale of a part of the property, between the part sold and the part retained. [Reg. 118, § 39.23(m)-8.]

§ 39.23(m)-11 Depletion and depreciation accounts on books. (a) Every taxpayer claiming and making a de-

duction for depletion and depreciation of mineral property shall keep accurate accounts in which shall be recorded the cost or other basis provided by section 113(a), as the case may be, of the mineral deposit and of the plant and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments required by section 113(b).

(b) . . . These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with §§ 39.23(m)-2, 39.23(m)-3, 39.23(m)-4, or 39.23(m)-5; or the amounts of the depletion and depreciation so computed shall be credited to depletion and depreciation reserve accounts, to the end that *when the sum of the credits for depletion* and depreciation *equals the cost or other basis of the property*, plus subsequent allowable capital additions, *no further deductions for depletion* and depreciation with respect to the property shall be allowed, except such depletion deductions as may thereafter be allowable under section 114(b) . . ., (3), . . . (i.e. percentage depletion).

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In the Superior Court of the State of California in and for the County of Alameda

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In the Matter of the Estate of William R. Sloan, also known as Wm. R. Sloan, also known as W. R. Sloan, Deceased.	No. 33064 Department No. 4

DECREE OF SETTLEMENT OF TWENTY-EIGHTH ACCOUNT AND REPORT OF SURVIVING TRUSTEE AND OF ADVICE TO SAID TRUSTEE

WELLS FARGO BANK AMERICAN TRUST COMPANY (formerly American Trust Company), surviving trustee of the trust created by the last will and testament of William R. Sloan, deceased, having on the 14th day of December, 1960 presented to and filed in this Court for settlement and confirmation its Twenty-eighth Account and Report and Petition for Compensation and for Advice, which account and report covered the administration of said trust for the period from October 31, 1959 to and including October 31, 1960;

Said Twenty-eighth Account and Report and Petition came on regularly for hearing the 30th day of December, 1960, in all respects as required by law.

WELLS FARGO BANK AMERICAN TRUST COMPANY, the surviving trustee, appeared personally at said hearing by Lynn Watson, an assistant trust officer of said bank, and by its counsel Messrs. Brobeck, Phleger and Harrison. Margaret Sloan St. Aubyn and Anna Logan Sloan Upton, daughters of the decedent and the present income beneficiaries named in the will, appeared by their counsel Everett S. Layman, Esq., and filed herein a written answer to said petition for advice.

At said hearing evidence, both oral and documentary, was introduced, and except in reference to compensation and other matters determined by the decree entered herein on December 30, 1960; the hearing of said account, report and petition, and of the answer thereto was continued until January 11, 1961, at 2 o'clock p.m., and *the Court being fully advised and having considered the evidence, including the opinion of the federal court hereinafter referred to, as well as the briefs before that court, and the memorandum of questions* NOW FINDS as follows:

. . . . . .

8. That attached to said Twenty-eighth Account and Report and marked Exhibit "D" and made a part thereof, is an allocation of the total distributable and retained income for the calendar year 1959, with an allocation of the necessary costs and expenses with respect thereto and of other deductions permitted for state and federal income

tax purposes, which said Exhibit shows the amount distributable to each of the present income beneficiaries and the amount to be retained by the trustee as provided by the decree of this Court settling the Nineteenth Account and Report of said trustees; that the allocations set forth therein are fair and just and in accordance with the said decree of this Court settling the said Nineteenth Account and Report; that the receipts as shown therein are properly allocable to the respective accounts as set forth therein, and that the disbursements set forth therein are properly allocated to the respective accounts as set forth therein; that as shown therein and as ordered by this Court in its decree settling said Nineteenth Account and Report, the income from the Richfield Royalties is properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustee, not as corpus or a reserve for depletion, but as an allocation of income); that the Pleasant Valley royalties are likewise properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustee, not as corpus or a reserve for depletion, but as an allocation of income);

9. That attached to said Twenty-eighth Account and Report, marked Exhibit "E" and by reference incorporated therein, is an allocation of the total distributable and retained income for the first ten months of the

calendar year 1960, with an allocation of certain of the necessary costs and expenses in respect thereto, other than certain expenses attributable to the Richfield and Pleasant Valley royalties, and of other deductions permitted for federal and state income tax purposes, which said Exhibit shows the amount distributable to each of the present income beneficiaries and the amount to be retained by the trustee as provided by the decree of this Court settling the Nineteenth Account and Report; that said allocations are fair and just and in accordance with the decree of this Court settling said Nineteenth Account and Report; that the receipts and disbursements shown therein are properly allocable to the respective accounts as set forth therein; that as shown therein and as ordered by this Court in its decree settling said Nineteenth Account and Report, the income from the Richfield and Pleasant Valley royalties is properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustee, not as corpus or a reserve for depletion, but as an allocation of income);

10. That the allocations made in Exhibits "D" and "E" were and are proper and in accordance with the decree of this Court settling the Nineteenth Account and Report herein, except as otherwise found in paragraphs 11 and 12 hereof; that no other or additional allocations are necessary or proper;

. . . . . .

14. That on or about May 19, 1953, but as of March 4, 1953, this Court duly made and entered its decree of advice and instructions to the then surviving trustees and its decree settling the Nineteenth Account and Report of the then surviving trustees (which said decree is hereinafter in this decree usually referred to as "said decree"). In all accounts since the entry of said decree, said decree has been treated by the surviving trustees as an adjudication allocating royalty income between the income beneficiaries and the trustees, and not as an adjudication that 27½% of all royalties, subject to and after payment of a fair share of necessary costs and expenses (a) was corpus of the trust, or (b) was required to be retained to preserve intact as corpus the value at the time of testator's death, or at any other time, of the asset producing such royalties, or (c) was required to be set aside as a reserve for depletion; that in accordance with said decree, said retained royalties, after and including November 1, 1951, have not been added to the capital account or corpus of the trust, but have been segregated into a separate and distinct account, namely the Retained Royalties Account which has been captioned "Retained Royalties Income Statement"; that this Court has been so advised in all such accounts and reports filed herein since the entry of said decree, and this Court has approved each such account and report as presented, with minor exceptions not material to these questions, and has approved the allocations made by the trustees in all said accounts and reports as being fair and just and in accordance with the

said decree; that an opinion of the United States Court of Appeals for the Ninth Circuit, filed September 27, 1960, questions the consistent construction of said decree so reported to, and approved by, this Court; and that said accounts and reports and all allocations made therein were and are in accordance with said decree; and

15. That William R. Sloan, the above named decedent; hereinafter in this decree for convenience usually called the testator, intended to include as income, as the word income is used in his will, all oil well royalties; the testator never intended to consider 27½% of all oil well royalties as corpus; the provision for 27½% as an allowable deduction for depletion was never heard of prior to testator's death;

16. That the trustees were not ordered by said decree to retain 27½% of royalty income on the theory that the testator intended 27½% of the royalties to represent return of capital; 27½ as percentage depletion had not been heard of at the time of the testator's death;

17. That this Court under its equitable powers could have authorized, and in and by said decree did authorize, the execution of the Richfield agreement for a period not authorized by the will, i.e. for a period beyond the termination of the trust, upon condition that a portion of the income therefrom be retained by the trustees;

18. That said decree does refer to, and allocates on the same basis, income from sources other than oil well royalties;

19. That the authority to execute the Richfield agreement and other agreements for a period beyond the termination of the trust was conditioned by said decree upon the retention of some income because, and only because, such agreements were not authorized by the will, and this Court did so in the exercise of its equitable powers;

20. That said decree does not provide that upon termination of the trust the retained royalties and investments derived therefrom be distributed as corpus of the trust; said decree does provide that upon termination, the retained royalties and investments derived therefrom "shall, pass and go, and be treated in all respects as if it were part of the property distributed to the trustees by said decree of final distribution"; the phrase "as if it were" indicates a condition contrary to a fact, namely that upon termination such an asset should be treated as if it were corpus, even though it is not corpus;

21. That this Court has repeatedly construed said decree as effectuating only an allocation of income as the word income is used in the will;

22. That insofar as the law of California is applicable, the testator's will does not provide that the trustees in determining the distributable royalties shall first make due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose; this Court in said decree did not fix 27½% as a reasonable amount of the royalties for the purpose of keeping intact the trust property or its value; this Court found that the mineral interests creating the Richfield royalties

had a nominal value at the time of the testator's death; sums in excess of $100,000 were and are not reasonable or necessary to preserve a corpus of nominal value;

23. That the Sloan will as construed by this Court in said decree did not require the trustees to retain part of the royalties as return of corpus;

24. That the retention of 27½% of the royalties, as required by said decree, reflected the application of the equitable powers of this Court where the will contained no provision authorizing the execution on favorable terms of the Richfield agreement, or any other agreement, for a period beyond the termination of the trust; it cannot be determined from reading the will as a whole that the testator intended the trustees to retain 27½% of the royalties, nor did said decree so determine;

25. That said opinion of the United States Circuit Court of Appeals for the Ninth Circuit, filed September 27, 1960, in speaking of said decree, in part states that this Court "apparently proceeded on the theory that the present value of the corpus is to be preserved"; the reference to "present value" presumably means value at or about the time of the hearing or of the entry of said decree; there was no evidence whatever before this Court as to the value of either the Cuyama mineral interests or the Pleasant Valley interest at the time of hearing before this Court, or at the time of said decree; there was evidence before this Court only that the value of all of the mineral rights in the Cuyama Area owned by testator "was $1,000 and no more at the time of his death and at

all times thereafter prior to January 1, 1945"; this Court made no findings whatever as to the value of either the Cuyama interests or the Pleasant Valley interest at the time of the hearing, or at the time of said decree; this Court did not proceed on the theory that the present value of the corpus was to be preserved; there was no evidence of such value; there was no finding of such value; written findings on a material issue are mandatory; a judgment or order not supported by findings of fact, when such findings have not been waived, is void; substantial evidence is required to support the findings and judgment;

26. That this Court did not order the retention of a portion of the royalty income on the theory that the testator intended this portion of the royalty income to represent return of capital, or a depletion reserve, or to preserve corpus; this Court did order the retention of a portion of the Richfield royalty income on the theory that the Richfield agreement as amended was unusually beneficial to the trust and all parties interested therein; that it was imperative that an agreement be made to prevent substantial damage by drainage; that such a favorable agreement could not be made if it could not be made for a period beyond the termination of the trust; that there was no express power in the will to make the agreement for a period beyond the termination of the trust, nor to allocate income, but this Court under its equitable powers did both for the best interests of all income beneficiaries of these trusts, and of all remaindermen of these trusts, whether vested or contingent; and

27. That in all accounts and reports filed by the surviving trustees or trustee since the entry of said decree, namely the 21st to the 28th, both inclusive, there is an allocation of the total distributable and retained income for the respective calendar years, with an allocation of the necessary costs and expenses with respect thereto and of other deductions permitted for state and federal income tax purposes for such year, and there is shown the amount distributable to each of the present income beneficiaries and the amount to be retained by the trustee as provided by said decree; that the allocations set forth in each thereof are fair and just and in accordance with said decree; that the receipts shown in each thereof are properly allocable to the respective accounts as set forth in each thereof, and that the disbursements set forth in each thereof are properly allocated to the respective accounts as set forth in each thereof; that as shown in each thereof and as ordered by this Court in said decree settling said Nineteenth Account and Report, the income from the Richfield royalties is properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustees or trustee, not as corpus or a reserve for depletion, but as an allocation of income); that the Pleasant Valley royalties are likewise properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustees

or trustee, not as corpus or a reserve for depletion, but as an allocation of income); and that all of the acts of said trustees or trustee so reported to this Court are approved and the trustee is now advised and instructed that such payments and allocations so reported are fair and just and in accordance with said decree, and that the decrees settling the 21st, 22nd, 23rd, 24th, 25th, 26th and 27th accounts and reports are in accordance with said decree.

The Court NOW *BEING FULLY AND FAIRLY ADVISED in the premises as to the questions at issue, and that a federal court has otherwise interpreted said decree,* does hereby ORDER, ADJUDGE, DECREE AND ADVISE as follows, to wit:

. . . . . .

I. IT IS FURTHER ORDERED, ADJUDGED AND DECREED:

(i) That on or about May 19, 1953, but as of March 4, 1953, this Court duly made and entered said decree; that in all accounts since the entry of said decree, said decree has been treated by the surviving trustees as an adjudication allocating royalty income between the income beneficiaries and the trustees, and not as an adjudication that 27½% of all royalties, subject to and after payment of a fair share of the necessary costs and expenses, (a) was corpus of the trust, or (b) was required to be retained to preserve intact as corpus the value at the time of the testator's death, or at any other time, of the asset producing such royalties, or (c) was required to be set

aside as a reserve for depletion; that in accordance with said decree, said retained royalties, after and including November 1, 1951, have not been added to the capital account or corpus of the trust, but have been segregated into a separate and distinct account, namely the Retained Royalties Account which has been captioned "Retained Royalties Income Statement"; that this Court has been so advised in all such accounts and reports filed herein since the entry of said decree, and this Court has approved each such account and report as presented, with minor exceptions not material to these questions, and has approved the allocations made by the trustees in all said accounts and reports as being fair and just and in accordance with said decree; that an opinion of the United States Court of Appeals for the Ninth Circuit, filed September 27, 1960, questions the consistent construction of said decree so reported to, and approved by, this Court; that said accounts and reports and all allocations made therein were and are in accordance with said decree; that said decree did provide for an allocation of royalty income from the Richfield lease and from the Pleasant Valley economic interests, and the trustee is so advised and instructed; that said decree did not provide, adjudicate or interpret the testator's will as directing that 27½% of all royalties, subject to and after payment of a fair share of the necessary costs and expenses, (a) was corpus of the trust, or (b) was required to be retained to preserve intact as corpus the value at the time of the testator's death, or at any other time, the asset or assets producing such royalties, or (c) was required to be set aside as a reserve for deple-

tion, and the trustee is so advised and instructed; that in and by said decree, income was allocated for retention under the equitable powers of this Court, because the will did not authorize a lease for a period beyond the termination of the trust, and the trustee is so advised and instructed; income was not allocated for retention as corpus or to preserve the corpus or its value, or as a reserve for depletion, and the trustee is so advised and instructed.

(ii) That the testator intended to include as income, as the word income is used in his will, all oil well royalties; the testator never intended to consider 27½% of all oil well royalties as corpus; the provision for 27½% as an allowable deduction for depletion was never heard of prior to testator's death;

(iii) That the trustees were not ordered by said decree to retain 27½% of royalty income on the theory that the testator intended 27½% of the royalties to represent return of capital; 27½ as percentage depletion had not been heard of at the time of the testator's death;

(iv) That this Court under its equitable powers could have authorized, and in and by said decree did authorize, the execution of the Richfield agreement for a period not authorized by the will, i.e. for a period beyond the termination of the trust, upon condition that a portion of the income therefrom be retained by the trustees;

(v) That said decree does refer to, and allocates on the same basis, income from sources other than oil well royalties;

(vi) That the authority to execute the Richfield agreement and other agreements for a period beyond the termination of the trust was conditioned by said decree upon the retention of some income because, and only because, such agreements were not authorized by the will, and this Court did so in the exercise of its equitable powers;

(vii) That said decree does not provide that upon termination of the trust the retained royalties and investments derived therefrom be distributed as corpus of the trust; said decree does provide that upon termination, the retained royalties and investments derived therefrom "shall pass and go, and be treated in all respects as if it were part of the property distributed to the trustees by said decree of final distribution"; the phrase "as if it were" indicates a condition contrary to a fact, namely that upon termination such an asset should be treated as if it were corpus, even though it is not corpus;

(viii) That this Court has repeatedly construed said decree as effectuating only an allocation of income as the word income is used in the will;

(ix) That insofar as the law of California is applicable, the testator's will does not provide that the trustees in determining the distributable royalties shall first make due allowance for keeping the trust property intact by retaining a reasonable amount of the royalties for that purpose; this Court in said decree did not fix 27½% as a reasonable amount of the royalties for the purpose of keeping intact the trust property or its value; this Court

found that the mineral interests creating the Richfield royalties had a nominal value at the time of the testator's death; that sums in excess of $100,000 were and are not reasonable or necessary to preserve a corpus of nominal value;

(x) That the Sloan will as construed by this Court in said decree did not require the trustees to retain part of the royalties as return of corpus;

(xi) That the retention of 27½% of the royalties as required by said decree reflected the application of the equitable powers of this Court where the will contained no provision authorizing the execution on the favorable terms of the Richfield agreement, or any other agreement, for a period beyond the termination of the trust; it cannot be determined from reading the will as a whole that the testator intended the trustees to retain 27½% of the royalties, nor did said decree so determine;

(xii) That said opinion of the United States Circuit Court of Appeals for the Ninth Circuit, filed September 27, 1960, in speaking of said decree, in part states that this Court "apparently proceeded on the theory that the present value of the corpus is to be preserved"; the reference to "present value" presumably means value at or about the time of the hearing or of the entry of said decree; there was no evidence whatever before this Court as to the value of either the Cuyama mineral interests or the Pleasant Valley interest at the time of hearing before this Court, or at the time of said decree; there was evidence before this Court only that the value of all of the mineral

rights in the Cuyama Area owned by testator "was $1,000 and no more at the time of his death and at all times thereafter prior to January 1, 1945"; this Court made no findings whatever as to the value of either the Cuyama interests or the Pleasant Valley interest at the time of the hearing, or at the time of said decree; this Court did not proceed on the theory that the present value of the corpus was to be preserved; there was no evidence of such value; there was no finding of such value; written findings on a material issue are mandatory; a judgment or order not supported by findings of fact, when such findings have not been waived, is void; substantial evidence is required to support the findings and judgment;

(xiii) That this Court did not order the retention of a portion of the royalty income on the theory that the testator intended this portion of the royalty income to represent return of capital, or a depletion reserve, or to preserve corpus; this Court did order the retention of a portion of the Richfield royalty income on the theory that the Richfield agreement as amended was unusually beneficial to the trust and all parties interested therein; that it was imperative that an agreement be made to prevent substantial damage by drainage; that such a favorable agreement could not be made if it could not be made for a period beyond the termination of the trust; that there was no express power in the will to make the agreement for a period beyond the termination of the trust, nor to allocate income, but this Court under its equitable powers did both for the best interests of all

income beneficiaries of these trusts, and of all remaindermen of these trusts, whether vested or contingent; and

(xiv) That in all accounts and reports filed by the surviving trustees or trustee since the entry of said decree, namely the 21st to the 28th, both inclusive, there is an allocation of the total distributable and retained income for the respective calendar years, with an allocation of the necessary costs and expenses with respect thereto and of other deductions permitted for state and federal income tax purposes for such years, and there is shown the amount distributable to each of the present income beneficiaries and the amount to be retained by the trustee as provided by said decree; that the allocations set forth in each thereof are fair and just and in accordance with said decree; that the receipts and disbursements shown in each thereof are properly allocable to the respective accounts as set forth in each thereof; that as shown in each thereof and as ordered by this Court in said decree settling said Nineteenth Account and Report, the income from the Richfield royalties is properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained by the trustees or trustee, not as corpus or a reserve for depletion, but as an allocation of income); that the Pleasant Valley royalties are likewise properly allocated 72½% to Trust No. 366 (distributable to Margaret Sloan St. Aubyn and Anna Logan Sloan Upton in equal shares), and 27½% to Trust No. 366-2 (to be retained

by the trustees or trustee, not as corpus or a reserve for depletion, but as an allocation of income); and that all of the acts of said trustees or trustee so reported to this Court are approved and the trustee is now advised and instructed that such payments and allocations so reported are fair and just and in accordance with said decree, and that the decrees settling the 21st, 22nd, 23rd, 24th, 25th, 26th and 27th accounts and reports are in accordance with said decree.

DONE IN OPEN COURT this 11th day of January, 1961.

/s/ A. J. Woolsey
JUDGE OF THE SUPERIOR COURT
(Emphasis Added)